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No. 874

In the Supreme Court of the United States

October Term, 1962

SAMUEL RICHARD PEARL, INCORPORATED, ET AL.,
PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

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In the Supreme Court of the United States

OCTOBER TERM, 1962

No. 874

FAMILY RECORD PLAN, INCORPORATED, ET AL.,
PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

OPINIONS BELOW

The findings of fact and opinion of the Tax Court (Pet. App. 48–62; R. 38a–38b, 39–53) are reported at 36 T.C. 305. The opinion of the court of appeals (Pet. App. 31–35) is reported at 309 F. 2d 208.

JURISDICTION

The judgment of the court of appeals was entered on October 22, 1962 (R. 118) and a petition for rehearing was denied on November 29, 1962 (R. 119). The petition for a writ of certiorari was filed on February 25, 1963. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

QUESTIONS PRESENTED

Pursuant to a plan of complete liquidation, the liquidating corporation sold receivables to an independent purchaser for $800,000. The corporation followed the cash method of accounting. The questions are:

1. Whether the Commissioner properly required the corporation to recognize as ordinary income the proceeds from its sale of the receivables.

2. Whether the amount paid for the stock of the corporation in anticipation of its liquidation reduced the gain realized by the corporation from its sale of the receivables.

STATUTE AND REGULATIONS INVOLVED

The pertinent provisions of Sections 334, 337, and 446 of the Internal Revenue Code of 1954, and Treasury Regulations on Income Tax (1954 Code), Section 1.446–1 appear in the Appendix, *infra*, pp. 13–16.

STATEMENT

This case involves the income taxes of Family Record Plan, Inc., hereafter referred to as the transferor, for the period from September 1, 1954, to February 28, 1955. The liability of Family Record Plan, Inc. as transferee for any taxes which may be found due from the transferor is conceded (Pet. App. 53; R. 43).

The transferor had been engaged for some years in the business of selling to the public a photograph album and the right to have portrait photographs taken at stated intervals, free of additional charge, by a studio

in the customer's vicinity. The customer's right to obtain the photographs was represented by a certificate and embodied in a written contract. A small down payment (usually $5 or $10) was made, and the balance was payable in monthly installments within nine months or less. When a customer had paid at least $10 on account, which was more than the album cost the transferor, the transferor would order an album to be shipped directly from the manufacturer to the customer. The transferor had written agreements with a large number of studios under which the studio agreed to take the pictures and supply one copy to the customer, without cost for the first copy either to the transferor or to the customer. Each customer's contract designated a studio. Once the customer got the album, the transferor's only remaining responsibility was to designate another studio if the named studio did not comply with the agreement, or if the customer moved, or, if there were no available studio, to enlarge, re-touch, print, and return to the customer a picture from a negative furnished by the customer. There is no evidence that the transferor was called upon to perform any of these obligations in connection with any contract involved in this case (Pet. App. 31–32, 49–50; R. 34, 39–40; Exs. E, F, G, H, I, L).

The transferee was organized for the purpose of buying the stock of the transferor, liquidating it, and continuing the business. The stockholders of the transferee had no connection with the prior stockholders of the transferor. On October 25, 1954, the trans-

feree bought all of the stock, for $1,120,000. It allocated $800,000 of the price on its books to the cost of the accounts receivable then owned by the transferor. These accounts represented payments owing to the transferor from its customers. After October 25, the transferor was a wholly owned subsidiary of the transferee (Pet. App. 32–33, 50; R. 40–41).

On December 10, 1954, the board of directors of the transferor adopted a plan of complete liquidation, and the transferee, as sole stockholder, consented. The plan required that transferor cease business, and it did so except for the assignment and collection of accounts receivable. The plan contemplated sale of "all or any part of the assets" of transferor. Liquidation was to be completed not later than November 30, 1955 (Pet. App. 33, 51; R. 35, 41).

On December 17, 1954, by written agreement the transferor sold all its outstanding contracts with its customers to independent parties named Smith. There were about 49,000 contracts with an unpaid balance of $1,390,331.91, including about 9,000 delinquent accounts in the hands of collection agencies with an unpaid balance of $319,801.77. The Smiths did not undertake to perform the contracts; all that they obtained was the right to the collections. The purchase price was $800,000, payable $200,000 down and the balance in installments with the final payment due not later than September 1, 1955. The sale was without recourse and the Smiths' obligation to pay was unconditional. The transferor was appointed agent of the Smiths to collect, the agency being irrevocable

until the price was paid or until September 1, 1955, and all net collections were to be applied on the price. In fact, the transferor's collections resulted in full payment by April 19, 1955 (Pet. App. 33, 51–52; R. 36, 41–42).

By February 28, 1955, all of the transferor's assets, including the contract with the Smiths, had been assigned to the transferee, and the transferor had been dissolved. The transfer of the Smith contract was made as of December 30, 1954. Of the collections on the customer contracts, $225,000 was paid to the transferor, and $575,000 was paid after January 1, 1955, to the transferee. It has been stipulated in this case (R. 38–38a) that, if any gain on the sale of the accounts "is recognized to transferor for federal income tax purposes, the amount of the gain to be included in income for the period September 1, 1954, to February 28, 1955, would be $800,000.00"[1] (Pet. App. 33–34, 52; R. 36–37, 42–43).

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[1] Petitioners object (Pet. 10–11) to the court of appeals' reliance on the stipulation between the parties which stated that, if any gain was to be recognized to the transferor, the amount should be $800,000 (R. 38–38a). It is undisputed that the stipulation was entered into by counsel during the Tax Court proceedings, and was filed later upon the Commissioner's motion with notice and without objection by petitioners. Moreover, both parties understood that the stipulation was before the Tax Court and the mutual concessions were repeated and relied upon by both parties in the briefs submitted to the Tax Court. In any event, petitioners only object to the stipulation on the ground that $575,000 of the $800,000 was paid by the Smiths to the transferee. However, this fact is immaterial, as the Tax Court pointed out (R. 52–53), since the $800,000 was payable to the transferor and it cannot evade income tax by turning its income over to the transferee. See *Helvering* v. *Horst*, 311 U.S. 112; *Helvering* v. *Eubank*, 311 U.S. 122.

Both the transferor and transferee were on the cash basis of accounting. In its final income tax return, the transferor did not include any part of the $800,000 in its income. The Commissioner included all of it. The Tax Court sustained the Commissioner, and the court of appeals affirmed. The dispute involves only the taxes of the transferor and the liability of the transferee as transferee; the taxes of the transferee on its own income are not involved (Pet. App. 34).

ARGUMENT

The main issue in this case is the same as that in *Kuckenberg* v. *Commissioner*, 309 F. 2d 202 (C.A. 9), petition for certiorari pending, No. 828, this Term. The decisions in these two cases were clearly correct, there are no conflicting decisions, and consequently there is no reason for further review by this Court.

1. In this case, as in *Kuckenberg*, during the course of liquidation a corporation, which followed a cash method of accounting, sold receivables which had been fully earned in the normal operation of the corporation's business. The earnings clearly were income of the corporation, which would be taxable as earned to an accrual-accounting taxpayer. Petitioners, however, are claiming an exemption from tax at ordinary income rates because the transferor corporation used a cash method of accounting and the receivables were sold before the customers paid the amounts owing. But it is well established that ordinary income cannot be changed into capital gains by the simple device of an anticipatory sale of the right to receive the amounts due. This Court has repeatedly

accorded the proceeds of such a sale the same ordinary-income treatment as would be accorded receipt of the earned sums in a transaction not involving any sale or exchange. *E.g., Helvering* v. *Horst*, 311 U.S. 112; *Helvering* v. *Eubank*, 311 U.S. 122.

Furthermore, Congress has provided in Section 446 (b) of the Internal Revenue Code of 1954, Appendix, *infra*, p. 15, that, if the method of accounting used by a taxpayer "does not clearly reflect income, the computation of taxable income shall be made under such method as, in the opinion of the Secretary or his delegate, does clearly reflect income." Not only the general method but also the particular treatment of each item must clearly reflect income. Treasury Regulations on Income Tax (1954 Code), Section 1.446–1, Appendix, *infra*, p. 16. In the case of a cash basis taxpayer which disposes of receivables in the course of liquidation, the cash method often would not clearly reflect income but would permit the unwarranted avoidance of tax upon amounts fully earned (but not yet received in cash) prior to liquidation. To reflect clearly the income of the liquidating and dissolving corporation, and to prevent the avoidance of tax by assignment of income, the Commissioner is authorized under Section 446(b) to require the revision of the accounting method of the corporation and the accrual of its income. *Idaho First National Bank* v. *United States*, 265 F. 2d 6 (C.A. 9); *Williamson* v. *United*

As to taxpayer's contention (Pet. 12–15) that the burden of proof was on the Commissioner, it should be noted, as the court below pointed out (Pet. App. 35), that the dispute was not as to the facts but as to the applicable legal rules.

States, 292 F. 2d 524 (C. Cls.); *Floyd* v. *Scofield*, 193 F. 2d 594 (C.A. 5).

2. Petitioners contend (Pet. 16–27) that Section 337 of the 1954 Code, Appendix, *infra*, pp. 14–15, requires nonrecognition of the transferor's income realized by the sale or assignment of accounts receivable. Section 337 provides that, if a corporation adopts a plan of liquidation and within twelve months thereafter distributes all its assets in complete liquidation, "then no gain or loss shall be recognized to such corporation from the sale or exchange by it of property within such 12-month period." This language, which confines nonrecognition to sales of "property" plainly does not exempt payments by customers for services which are made within the twelve-month period. Subsection (b) of Section 337 expressly exempts inventory from the nonrecognition provisions. Thus, Section 337 is clearly and intentionally limited so as to preserve the general requirement of recognition by the liquidating corporation of its current earnings whether from services or sales of inventory. This case, which involves accounts receivable for the rendering of services, does not come within the nonrecognition provisions of Section 337 unless "property" may be extended to include a contract right or account receivable. If this expansion of Section 337 were allowed, every cash basis taxpayer could readily obtain exemption for all payments for services or inventory by merely selling the right to be paid before the time of payment as part of a plan of liquidation. We submit that the meaning of "property" as used in Section 337 cannot be expanded to override the careful limitations which Congress provided.

In addition, petitioners' contention is inconsistent with the purpose of Section 337. That section was intended to eliminate the problems under prior law which imposed a tax upon a corporation if it sold its physical properties and distributed the proceeds as liquidating dividends, but imposed no tax upon the corporation if it distributed the same assets in kind and the shareholders then sold them. S. Rep. No. 1622, 83d Cong., 2d Sess., p. 258 (3 U.S.C. Cong. & Adm. News (1954) 4621, 4896). There is no indication that Section 337 was intended to permit a cash basis corporation to avoid income tax on its earnings by assigning rights to income in the course of liquidation. Such an interpretation would create an inequitable discrimination between various liquidating corporations in favor of cash basis taxpayers and against accrual basis taxpayers; Section 337 was designed to avoid just such formal distinctions. Accordingly, in cases involving sales of the right to be paid representing income previously earned but not taxed, the courts have held that Section 337 does not allow nonrecognition of the gain and therefore have required the inclusion of the earnings in the liquidating corporation's taxable income. *West Seattle National Bank of Seattle* v. *Commissioner*, 288 F. 2d 47 (C.A. 9); *Citizens Federal S. & L. Ass'n of Cleveland* v. *United States*, 290 F. 2d 932 (C. Cls.); *Central Building & Loan Association* v. *Commissioner*, 34 T.C. 447. See also *Williamson* v. *United States*, 292 F. 2d 524 (C. Cls.); Rev. Rul. 59-120, 1959-1 Cum. Bull. 74.

3. Petitioners also contend (Pet. 7-10) that the so-called *Kimbell-Diamond* rule and the partial codification of that rule in Section 334(b)(2) of the 1954

Code, *infra*, pp. 13–14, established that the basis of property received by the transferee through the purchase of the stock of the transferor and the liquidation of that corporation may be determined by reference to the adjusted basis of the stock—*i.e.*, here, the cost to the transferee of the stock. Petitioners assert (Pet. 9) that "[t]he portion of the cost of the stock attributable to the [receivables] was $800,000," that the transferee had no gain from sale of the accounts receivable since they were sold for $800,000, and that the transferor had no gain from the sale of accounts receivable because in effect they were sold by the transferee.

This contention is entirely without substance. The *Kimbell-Diamond* rule and Section 334(b)(2) relate solely to the basis of assets in the hands of the transferee corporation. This case, on the other hand, concerns exclusively the taxes payable by the transferor corporation.[3] Under petitioners' theory, the transferor received $800,000 for the receivables from the transferee and the transferee sold them. While, we submit, the accounts receivable were in fact sold by the transferor, not by the transferee (Pet. App. 33, 51; R. 26, 36, 41), it is immaterial which corporation sold the receivables. In either event, the trans-

[3] The transferee corporation is a party merely because the transferor has been dissolved and the transferee is liable for taxes owed by the transferor.

feror received $800,000 for the receivables and, as we have seen, it is required to recognize this gain.[4]

CONCLUSION

For the foregoing reasons, we respectfully submit that the petition for a writ of certiorari should be denied.

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APRIL 1963.

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[4] *United States* v. *M.O.J. Corp.*, 274 F. 2d 713 (C.A. 5), acquiesced, Rev. Rul. 60-246, 1960-2 Cum. Bull. 462, involved a question of basis in the hands of the purchaser. It is not in conflict with the decision below since in this case ~~the purchaser never held the receivables and there is no question of basis.~~ involves the basis of the transferor

APPENDIX

Internal Revenue Code of 1954:

SEC. 334. BASIS OF PROPERTY RECEIVED IN LIQUIDATIONS.

* * * * * * *

(b) LIQUIDATION OF SUBSIDIARY.—

(1) IN GENERAL.— * * *.

(2) EXCEPTION.—If property is received by a corporation in a distribution in complete liquidation of another corporation (within the meaning of section 332(b)), and if—

(A) the distribution is pursuant to a plan of liquidation adopted—

(i) on or after June 22, 1954, and

(ii) not more than 2 years after the date of the transaction described in subparagraph (B) (or, in the case of a series of transactions, the date of the last such transaction); and

(B) stock of the distributing corporation possessing at least 80 percent of the total combined voting power of all classes of stock entitled to vote, and at least 80 percent of the total number of shares of all other classes of stock (except nonvoting stock which is limited and preferred as to dividends), was acquired by the distributee by purchase (as defined in paragraph (3)) during a period of not more than 12 months,

then the basis of the property in the hands of the distributee shall be the adjusted basis of the stock with respect to which the distribution was made. For purposes of the preceding sentence, under regulations prescribed by the Secretary or his delegate, proper adjustment in the adjusted basis of any stock shall be made for any distribution made to the distributee with respect to such stock be-

fore the adoption of the plan of liquidation, for any money received, for any liabilities assumed or subject to which the property was received, and for other items.

* * * * *

SEC. 337. GAIN OR LOSS ON SALES OR EXCHANGES IN CONNECTION WITH CERTAIN LIQUIDATIONS.

(a) GENERAL RULE.—If—

(1) a corporation adopts a plan of complete liquidation on or after June 22, 1954, and

(2) within the 12-month period beginning on the date of the adoption of such plan, all of the assets of the corporation are distributed in complete liquidation, less assets retained to meet claims,

then no gain or loss shall be recognized to such corporation from the sale or exchange by it of property within such 12-month period.

(b) PROPERTY DEFINED.—

(1) IN GENERAL.—For purposes of subsection (a), the term "property" does not include—

(A) stock in trade of the corporation, or other property of a kind which would properly be included in the inventory of the corporation if on hand at the close of the taxable year, and property held by the corporation primarily for sale to customers in the ordinary course of its trade or business,

(B) installment obligations acquired in respect of the sale or exchange (without regard to whether such sale or exchange occurred before, on, or after the date of the adoption of the plan referred to in subsection (a)) of stock in trade or other property described in subparagraph (A) of this paragraph, and

(C) installment obligations acquired in respect of property (other than property described in subparagraph (A)) sold or exchanged before the date of the adoption of such plan of liquidation.

(2) Nonrecognition with respect to inventory in certain cases.—Notwithstanding paragraph (1) of this subsection, if substantially all of the property described in subparagraph (A) of such paragraph (1), which is attributable to a trade or business of the corporation is, in accordance with this section, sold or exchanged to one person in one transaction, then for purposes of subsection (a) the term "property" includes—

(A) such property so sold or exchanged, and

(B) installment obligations acquired in respect of such sale or exchange.

* * * * *

SEC. 446. GENERAL RULE FOR METHODS OF ACCOUNTING.

(a) GENERAL RULE.—Taxable income shall be computed under the method of accounting on the basis of which the taxpayer regularly computes his income in keeping his books.

(b) EXCEPTIONS.—If no method of accounting has been regularly used by the taxpayer, or if the method used does not clearly reflect income, the computation of taxable income shall be made under such method as, in the opinion of the Secretary or his delegate, does clearly reflect income.

(c) PERMISSIBLE METHODS.—Subject to the provisions of subsections (a) and (b), a taxpayer may compute taxable income under any of the following methods of accounting—

(1) the cash receipts and disbursements method;

(2) an accrual method;

(3) any other method permitted by this chapter; or

(4) any combination of the foregoing methods permitted under regulations prescribed by the Secretary or his delegate.

Treasury Regulations on Income Tax (1954 Code):

SEC. 1.446–1. GENERAL RULE FOR METHODS OF ACCOUNTING.

(a) GENERAL RULE. (1) Section 446(a) provides that taxable income shall be computed under the method of accounting on the basis of which a taxpayer regularly computes his income in keeping his books. The term "method of accounting" includes not only the over-all method of accounting of the taxpayer but also the accounting treatment of any item. * * *

(2) It is recognized that no uniform method of accounting can be prescribed for all taxpayers. Each taxpayer shall adopt such forms and systems as are, in his judgment, best suited to his needs. However, no method of accounting is acceptable unless, in the opinion of the Commissioner, it clearly reflects income. A method of accounting which reflects the consistent application of generally accepted accounting principles in a particular trade or business in accordance with accepted conditions or practices in that trade or business will ordinarily be regarded as clearly reflecting income, provided all items of gross income and expense are treated consistently from year to year.

* * * * *

(b) EXCEPTIONS. (1) If the taxpayer does not regularly employ a method of accounting which clearly reflects his income, the computation of taxable income shall be made in a manner which, in the opinion of the Commissioner, does clearly reflect income.

* * * * *

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